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(Excerpt)

It's not the blowing of the wind, but the set of your sails

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The 2008 worldwide financial meltdown was most certainly unwelcome and raised a great deal of fear among us all. Although we would be hard-pressed to find many positives in this bad experience, hopefully the mistakes that led to the disaster will not be repeated. Unfortunately, it seems that the remedy that is being used to kick-start the economy is the same poison that got us into this mess in the first place, and that is "excessive credit". This time, our governments and central banks are the ones carrying the burden, rather than consumers and financial institutions fuelled by greed. It seems that the growing debt burden has been moving its way up the ladder. Eventually, though, it can reach the ultimate level (or the last step on the ladder) where there is be nobody left to pass it on to, and at which point government debt becomes "junk". The drop in credit ratings means that the cost of financing becomes unaffordable, and unacceptable concessions are imposed on the voting population in order to curb government spending and raise revenue. We have been hearing a lot about Greece in recent weeks, but other countries are trailing not so far behind and tough measures must be imposed where need be, and sooner rather than later. Hopefully, social and political unrest can be avoided… Those other countries we are referring to are also known collectively as "PIGS" – Portugal, Italy, Iceland and Ireland, Greece and Spain – and all are suffering from excessive debt and poor economic growth. But over the short-term, all eyes are trained on Greece, and the outcome might well be a new platform or contingency plan the IMF (International Monetary Fund) and the EU (European Union) could put forward to support other troubled nations.

The US is certainly not immune to such risks and has been leading the pack in terms of economic stimulus. US deficits are growing at record pace, but the country still has an ace up its sleeve that nobody else in the industrial world has and that is that the US is the least taxed nation in the world. However, higher taxes are not welcome in the US, as they tend to contract consumer spending and consequently economic growth. But that ace is still there. Assuming a very strong rebound in economic indicators in the coming quarters, which I believe will happen, monetary policy will tighten slowly but surely. As economic growth is sustained, perhaps at a lower pace, say 3% to 4%, certain forms of taxes might be proposed that would allow the US to reduce the deficit and become a greener country as well. A tax on gas, for example, could be introduced where they could invest part of the proceeds to convert some 14 million diesel transport trucks to cleaner natural gas, reducing emissions as well as the deficit. So the US might be living difficult times and dealing with a lot of issues at once but if anything, the US market may surprise us on the upside in the next two to three years. Perhaps, as happened in most countries post-financial crisis, the banking sector will have to lead the US market out of this nasty recession. However, given the very fragmented US banking system, not all US banks will make it. In fact, a record number of US banks are failing and that drives consolidation further. At this point it is believed that nearly 50% of the US banking market share is controlled by four pillars, namely Citigroup, Bank of America, JP Morgan and Wells Fargo. But beware, bigger is not necessarily better!

Meanwhile, the Canadian economy has been improving considerably as a result of the significant North American government interventions and the Central Banks' accommodative monetary policy. Combined with unprecedented government spending, keeping interest rates at such low levels has proven to be the 1-2 punch needed to kick start the economy. Our stronger, more conservative and restrictive banking system has certainly played a key role in the strength of our recovery. Home sales, existing home prices and Canadian retail sales are all back to where they were before the financial crisis (**chart 1**).

Chart 1

Source: BMO Capital Markets

The S&P500 has experienced the fastest and steepest recovery compared to the six previous recessions, as shown in **chart 2**.

Chart 2

Source: BMO Capital Markets

Last quarter, the Canadian GDP reached 5% and it could rise even higher given the unprecedented amount of stimulus. Our federal government's $13 billion infrastructure stimulus plan announced last year has awarded funding to some 6,700 projects, of which only half are completed or underway according to what our infrastructure minister John Baird indicated in February. He also stated that, including funding from other levels of government, the total estimated value of currently ongoing projects is approximately $27 billion. What is most important is that the bulk of the stimulus program will be spent in 2010 (i.e. some 50% in 2010 and a balance of 20% in 2011) and should have a favorable impact on economic growth and ultimately on corporate earnings. Short-term, there is no question that stimulus is achieving what it is supposed to. Over the longer-term, though, tough measures will have to be imposed so that growing deficits are kept under control and can be funded and absorbed without restricting growth.

With the wind blowing in our back, the stock market has been on a tear. While corporations and consumers are taking advantage of cheap and easy money, the markets are discounting earnings growth, helping the economy turn the corner. But as we negotiate the turn, we will eventually stand facing the wind (when monetary policy tightens and government spending contracts). Some countries around the world, such as China and Australia, have turned the corner ahead of us and have already begun to raise their interest rates. Canada is expected to be not too far behind. These actions may drive the loonie up somewhat and that may damper on our economic growth.

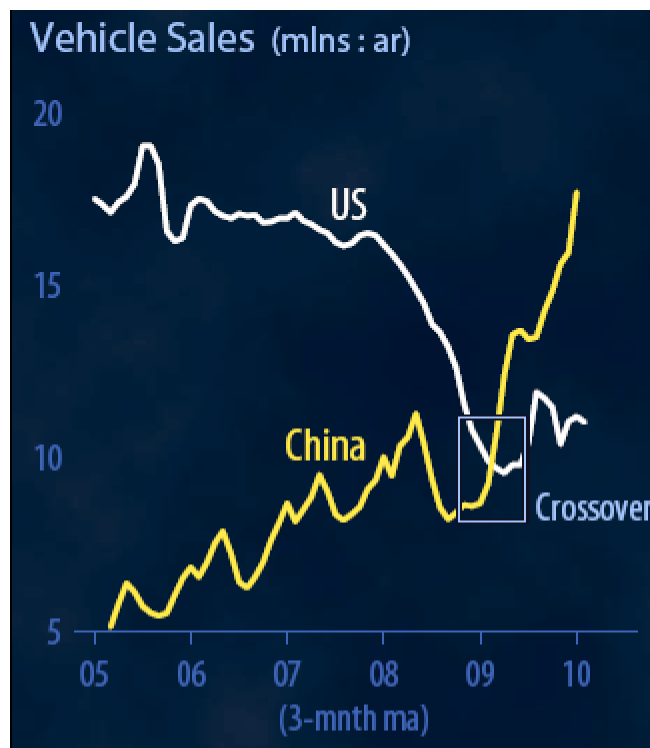
However, the sheer thrust of the expansion, combined with our strong banking system, should allow corporate Canada to maintain a good momentum going forward.

When we look at the whole picture, there are some very important issues that the Western world is facing, which cannot be overlooked and might result in some adjustments to our investment strategy.

It is believed that only a quarter to a third of the Chinese population has reached middle class status…Car sales say a lot about what is going on in China (chart 3). Think of roads, energy, car parts, repair shops, jobs, raw materials (steel, aluminum, platinum, etc.)… Can you imagine investing in a toll road in China (such as the 407 in Toronto) for the next twenty years considering the increasing number of cars in that country? The crossover is a reflection of the unstoppable momentum, demography-led, driving China's growth.

Chart 3

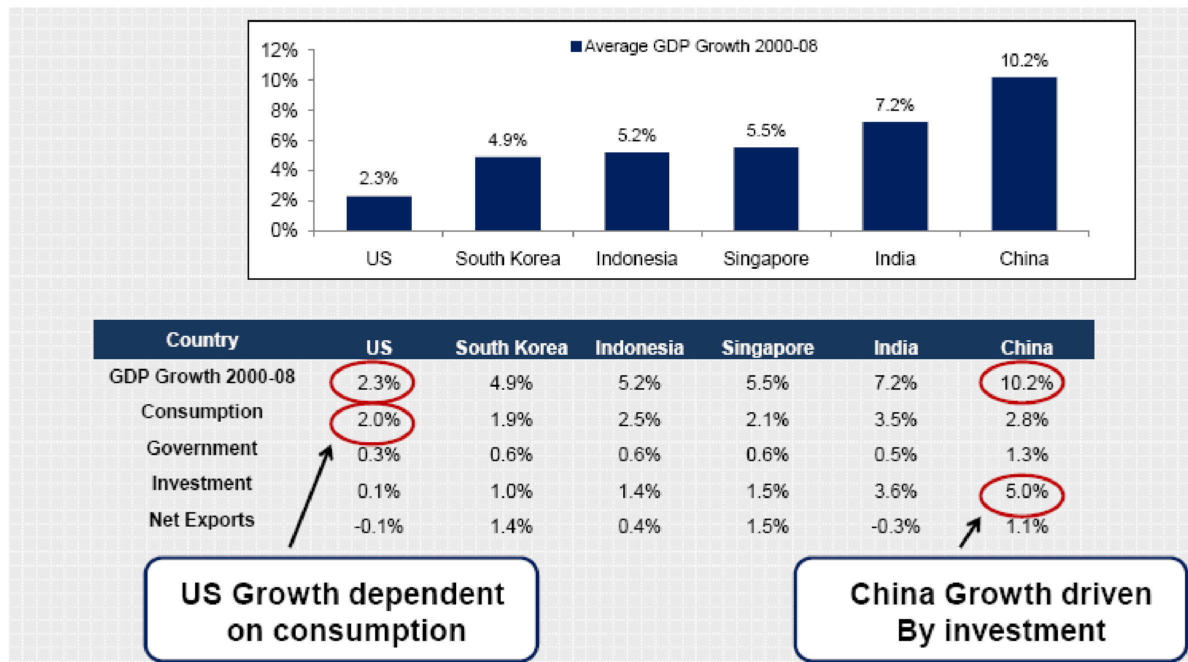
Vehicle sales – US vs. China



Source: BMO Capital Markets

For the past 10 years or so, China has used its growth to reinvest and expand. Chart 4 shows that half of China's growth has been driven by investment. That compares favorably to US growth, which relies mostly on consumer spending. A better balance between consumption and investment would be more appropriate.

Chart 4 **2000-2008 GDP growth – US vs. BRIC Plus**

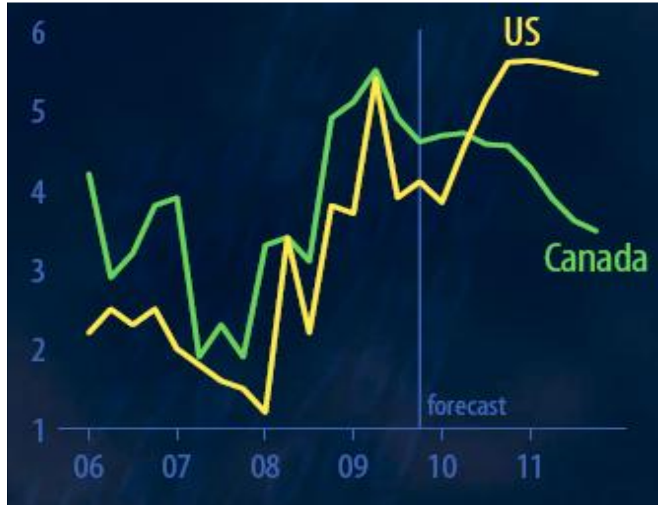


Country	US	South Korea	Indonesia	Singapore	India	China
GDP Growth 2000-08	2.3%	4.9%	5.2%	5.5%	7.2%	10.2%
Consumption	2.0%	1.9%	2.5%	2.1%	3.5%	2.8%
Government	0.3%	0.6%	0.6%	0.6%	0.5%	1.3%
Investment	0.1%	1.0%	1.4%	1.5%	3.6%	5.0%
Net Exports	-0.1%	1.4%	0.4%	1.5%	-0.3%	1.1%

Source: Prasad et al (2009); CEIC, IMF, ADB

In addition, American consumers have slowed down their spending habits. Chart 5 shows that Americans have drastically increased their savings, which has now reached the highest level over two decades. As the US tries to stimulate growth, the country is pushing its debt levels into uncharted territory, while consumers, especially baby boomers, are becoming progressively concerned about their future financial strength and retirement.

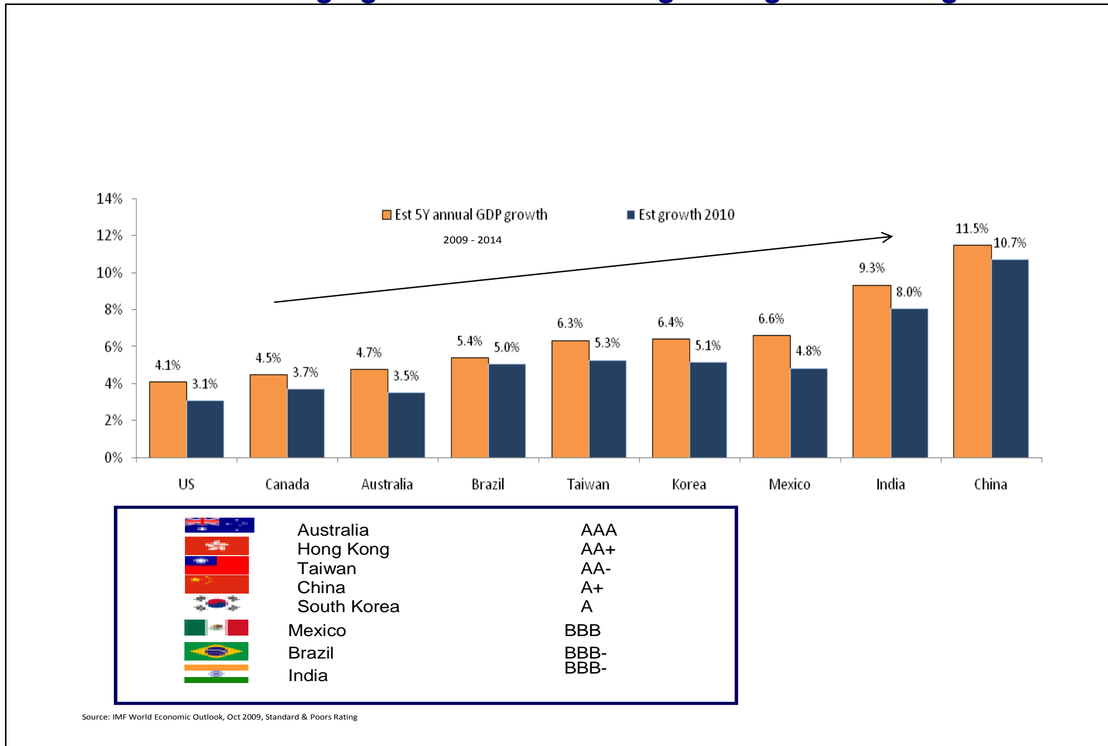
Chart 5 **Consumer savings rates – Canada vs. US**



Source: BMO Capital Markets

Chart 6

Projected GDP growth
North America vs. emerging countries and strengthening credit ratings



Source: IMF World Economic Outlook Oct 2009 Standard & Poors Rating

Given that future growth is a reflection of today's fiscal and financial discipline, Chart 6 shows how emerging markets are expected to fully benefit over the next five years. As a result, their credit ratings will gradually strengthen, attracting more investments at a lower relative cost of financing.

At one point, America, the economic powerhouse and intellectual think tank of the world, became obsessed with profits. They used the cheapest labor force they could find to develop and produce their technologies. Decades went by, greed overcame capitalism. Overconfident and feeling invincible, they let financial discipline fly out the window. We are now paying the price: staggering deficits, an aging population, and underfunded pension plans. This situation is apparent in the European Union as well, as in most of the Western world. Meanwhile, China and many emerging countries have developed skills and knowledge from the intellectual property transferred from the West. Although they are discovering new and more comfortable lifestyles, they haven't fallen into the debt spiral yet. Their low currency allows them to be extremely competitive, but that could become to their own detriment if the Western world consumers cut deeply in their spending habits or, worse yet, protectionism sets in. A stronger Yuan would allow for a better balance of trade and would make the Chinese richer on the world stage. It is a known fact that a strong currency attracts foreign capital, and that facilitates financing abroad, which in turn stimulates growth. When that spiral blooms, shouldn't we all "follow the money"?

Seven years ago (in Newsletter #32), I wrote about the over weighted US component as part of the MSCI World index. Its weight then stood at 52%, down from a record high of 58% in 2000, and I suggested that over time, it would shrink even more as emerging markets were expected to grow at a faster pace. Today, the US weighting stands at about 42% (Table 1).

Table 1

Figure 2: MSCI ACWI - Allocation Changes

	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09
USA	52.5%	50.1%	47.8%	44.7%	41.8%	45.0%	41.9%
UK	10.5%	10.5%	10.1%	10.4%	9.6%	8.4%	8.8%
Dev. Europe x UK	18.3%	19.1%	17.9%	19.9%	20.8%	19.1%	18.4%
Japan	8.6%	9.2%	10.8%	9.9%	8.6%	10.6%	8.4%
Australia	2.0%	2.1%	2.2%	2.4%	2.8%	2.5%	3.4%
Canada	2.5%	2.8%	3.2%	3.2%	3.7%	3.5%	4.2%
Brazil	0.4%	0.5%	0.7%	0.9%	1.5%	1.2%	2.2%
Russia	0.2%	0.2%	0.4%	0.9%	1.2%	0.5%	0.8%
India	0.3%	0.3%	0.4%	0.5%	0.9%	0.6%	1.0%
China	0.4%	0.4%	0.5%	1.0%	1.8%	1.7%	2.3%
Korea	0.8%	0.9%	1.3%	1.3%	1.6%	1.3%	1.7%
Taiwan	0.6%	0.7%	1.0%	1.0%	1.1%	1.0%	1.5%
South Africa	0.6%	0.6%	0.7%	0.7%	0.8%	0.8%	0.9%
Developed	**95.5%**	**94.8%**	**93.2%**	**91.8%**	**88.7%**	**90.5%**	**87.0%**
Emerging	**4.5%**	**5.2%**	**6.8%**	**8.2%**	**11.3%**	**9.5%**	**13.0%**

Source: MSCI

During that period of time (2000-2010), the S&P500 index recorded its first decade ever with a negative return of -.5%. Canada, which exports a lot of raw materials to China, has seen its MSCI weighting almost double. It's no coincidence that Canadian markets outperformed the US in the same time frame. Based on the IMF GDP growth forecasts, as seen in chart 6, Mr. Michael Edmonds, Senior Analyst at City of London Investment Management, expects the emerging market weighting expansion to continue to outpace that of developed countries (see the MSCI Analysis article on our web site).

Although we have been avoiding the US market since 1997, and concentrating our investments in Canada, we believe that the time has come to build a position in emerging markets. US stocks can be attractive if their business model, sales and development are largely focused and expanding in emerging markets. In our last Newsletter #42, we suggested using a combination of Dynamic Global and Far East equity funds and BRIC ETF (Brazil, Russia, India and China Exchange Traded Funds) as a way to start building a position on foreign markets. While the Dynamic fund carries a significant management fee, the BRIC ETF is unmanaged and is limited to those four countries. A recently-launched fund has a lower management fee and an investment philosophy that is basically an extension of our own. The fund comprises 40% corporate bonds, 20% convertible debentures and preferred shares and 40% income-generating equities. It will cover the BRIC countries, with the exception of Russia for the foreseeable future, and all emerging regional economies such as Mexico, Taiwan, Indonesia, Korea, etc. It intends to distribute a minimum of 5% income per annum as well.

Conclusion:

The world's economic strength is shifting, creating investment opportunities. The West faces huge and unprecedented current account deficits, while the East enjoys surpluses. Demographics are also more favorable in the East. This rebalancing of power is self-sustaining: as it attracts more capital, pushes the currency higher over time, offsets some inflationary pressures, creates relative wealth and stimulates consumption. Americans have seen how that cycle works over the last century. While investing abroad adds a currency risk, investing in a faster growing part of the world should add value to your investment. Canada is very well positioned to capitalize on the expansion of emerging markets as we have a strong balance sheet, the best banking system and all the commodities the world needs right here at home. Not only did we take a record number of gold medals during the 2010 Winter Olympics, we have plenty of gold in our backyards as well.

History shows the creation of wealth triggered by printing money is not a long-term solution. Current economic indicators are showing that this strategy works over the short-term, and hopefully central banks will act responsibly. However, mistakes can occur and the potential lack of discipline on the Fed's part means that we should have our own "Central Bank". In the 30's, the Great Depression could not be avoided because the Central Bank could not print more money than what the gold reserves allowed. Today, they are printing fearlessly and some would say recklessly. We might avoid a depression, but at what cost? Having our own little Central Bank with some gold reserves to ensure and protect our buying power worldwide is an idea that makes sense to us.

Aside from gold, minimum weightings in energy, agriculture and base metals would be appropriate to counter creeping inflation. The consumer staples and real estate sectors provide some inflationary protection as well and, in certain cases, a stable income flow. Banks have surprised us with the sharpness of their recovery. Although they provide a very attractive source of dividend income for investors, they usually underperform in a rising interest rate environment.

Given the high probability of a contracting monetary policy in the near future, beware of companies with a high level of debt. Stick to companies with high quality balance sheets and a good dividend policy, and maintain a minimum of 20% of the equity portion of your portfolio in inflation-sensitive stocks.

RECOMMENDED ASSET MIX

INCOME PORTFOLIO			BALANCED PORTFOLIO	
Oct 2009	Apr 2010		Oct 2009	Apr 2010
20%	15%	CASH (CSB, QSB, T-BILLS)	20%	10%
50%	50%	FIXED INCOME (BONDS)	30%	30%
10%	15%	CONVERTIBLE DEBS. AND INCOME GENERATING SECURITIES	10%	15%
15%	15%	EQUITIES	35%	35%
5%	5%	FOREIGN	5%	10%

INCOME-GENERATING INVESTMENTS

	CURRENT PRICE	DISTRIBUTION MONTH-LY	DISTRIBUTION QUARTER LY	DISTRIBUTION SEMI-ANNUAL	ANNUAL DISTR. $	CURRENT YIELD	YIELD TO MATURITY	ESTIMATED % TAXABLE	(1) CURRENT AFTER-TAX YIELD	RECOMME NDATION	TARGET PRICE	(2) CREDIT RATING CBRS
DEBENTURE												
CDN DEBENTURE FUND	$10.70	0.0625			$0.75	7.01%		100%	3.50%	Buy		
INCOME TRUST (3)												
ARC ENERGY	$20.50	0.1			$1.20	5.85%		100%	2.93%	Buy	$24.00	
BELL ALIANT	$25.40	0.2417			$2.90	11.42%		90%	6.28%	Buy	$27.00	S-2
CANADIAN OIL SAND	$30.45		0.4		$1.60	5.25%		90%	2.89%	Buy	$34.00	S-4
FORT CHICAGO ENERGY	$10.82	0.0775			$0.93	8.60%		98%	4.38%	Hold	$11.00	S-2
GAZ MÉTROPOLITAIN PTS	$16.22		0.31		$1.24	7.64%		100%	3.82%	Sell	$17.00	S-1
GENIVAR	$28.28	0.125			$1.50	5.30%		100%	2.65%	Hold	$30.00	
GREAT LAKES HYDRO	$21.00	0.1042			$1.25	5.95%		46%	4.58%	Hold	$20.00	S-2
INNERGEX POWER	$12.30	0.0833			$1.00	8.13%		41%	6.46%	Hold	$11.00	S-2
LABRADOR IRON ORE	$53.58		0.55		$2.20	4.11%		100%	2.05%	Hold		S-3
NORTHLAND POWER	$13.16	0.09			$1.08	8.21%		100%	4.10%	Hold	$13.00	S-2
PEMBINA PIPELINES	$17.41	0.13			$1.56	8.96%		85%	5.15%	Hold	$16.00	
RIOCAN	$18.48	0.115			$1.38	7.47%		63%	5.12%	Hold	$19.00	S-2
WESTSHORE TERMINALS	$16.05		0.29		$1.16	7.23%		100%	3.61%	Hold	$11.50	S-4
YELLOW PAGE	$6.15	0.0667			$0.80	13.01%		100%	6.51%	Sell	$5.75	S-2
STOCKS												
CRESCENT POINT ENERGY	$38.97	0.23			$2.76	7.08%		95%	3.72%	Buy	$45.00	
O'LEARY BRIC	$11.72	0.05			$0.60	5.12%		100%	2.56%	Buy		

1) Assuming a 50% marginal tax rate.
2) Varies between S1 to S7, S1 being the highest
3) Income may be subject to fluctuations.

Sources:
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BMO Capital Markets (chart #1, 2, 3, 5)
Prasad et al (2009); CEIC, IMF, ADB (chart #4)
IMF World Economic Outlook Oct 2009 Standard & Poors Rating (chart #6)
Morgan Stanley Capital Index (table #1)

[1] The opinions, estimates and projections contained herein are those of the author as of the date hereof and are subject to change without notice and may not reflect those of BMO Nesbitt Burns Inc. ("BMO NBI"). Every effort has been made to ensure that the contents have been compiled or derived from sources believed to be reliable and contain information and opinions that are accurate and complete. Information may be available to BMO Nesbitt Burns or its affiliates that is not reflected herein. However, neither the author nor BMO NBI makes any representation or warranty, express or implied, in respect thereof, takes any responsibility for any errors or omissions which may be contained herein or accepts any liability whatsoever for any loss arising from any use of or reliance on this report or its contents. This report is not to be construed as an offer to sell or a solicitation for or an offer to buy any securities. BMO NBI, its affiliates and/or their respective officers, directors or employees may from time to time acquire, hold or sell securities mentioned herein as principal or agent. BMO Nesbitt Burns Inc. and BMO Nesbitt Burns Ltee/Ltd. ("BMO Nesbitt Burns") will buy from or sell to customers securities of issuers mentioned herein on a principal basis. BMO Nesbitt Burns, its affiliates, officers, directors or employees may have a long or short position in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. BMO Nesbitt Burns or its affiliates may act as financial advisor and/or underwriter for the issuers mentioned herein and may receive remuneration for same. A significant lending relationship may exist between Bank of Montreal, or its affiliates, and certain of the issuers mentioned herein. BMO NBI is a wholly owned subsidiary of BMO Nesbitt Burns Corporation Limited which is a majority-owned subsidiary of Bank of Montreal. Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Nesbitt Burns Corp. and/or BMO Nesbitt Burns Securities Ltd.

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